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**REPORT FROM THE COMMISSION TO THE COUNCIL AND THE EUROPEAN
PARLIAMENT**

**on the use of administrative cooperation arrangements
in the fight against VAT fraud**

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1. SUMMARY

The transitional VAT arrangements are designed so that intra-Community supplies of goods between taxable persons are exempt in the goods' Member State of origin, with taxation taking place in the Member State of destination. These "normal" arrangements have been supplemented by many special, often complex arrangements in areas in which the Member States wanted to maintain more extensive control over taxation.

This exemption mechanism exposes the VAT system to fraud, and in particular intra-Community "carousel" fraud. Since goods can move without being taxed, it is important that the Community administrative cooperation arrangements be used as effectively as possible and that national control systems be adapted to these challenges.

In its last report on administrative cooperation and VAT control procedures the Commission regretted that these conditions had yet to be fulfilled.¹ Accordingly, the Council, at its ECOFIN meeting of 5 June 2000, called on the Commission and the Member States to launch a series of measures aimed at stepping up action against tax fraud under the current VAT arrangements.

Many initiatives have been taken in follow-up to these recommendations and have been coordinated by the Standing Committee on Administrative Cooperation (SCAC).

At Community level, the Council has recently adopted Regulation (EC) No 1798/2003,² which considerably reinforces the legal framework for mutual assistance; it has also adopted a decision on the Fiscalis 2003-2007 programme,³ which provides funding for greater day-to-day cooperation. The Commission has also announced its intention to overhaul the VIES system in the medium term.⁴

The Member States have, for their part, made appreciable progress towards more modern and effective VAT controls, and they are beginning to integrate administrative cooperation into their day-to-day control practices. However, this is not enough; more is required, especially with regard to providing the national departments responsible for mutual assistance with adequate staffing.

There has recently been much discussion aimed at identifying what further measures could be taken to combat carousel fraud even more effectively.

One solution is a radical reform of the way VAT control is organised. A list of good practices has been drawn up. The Member States which have gone down this road are already recording considerable successes.

Some national authorities, professionals and academics have proposed another solution, namely to reform the working of the VAT system itself. Various options exist, but all have disadvantages which far outweigh the potential benefits.

¹ COM(2000) 28 final of 28.1.2000.

² OJ L 264, 15.10.2003, p. 1.

³ Decision 2235/2002/EC of the European Parliament and of the Council of 3 December 2002 (OJ L 341, 17.12.2002).

⁴ VAT Information Exchange System.

The report therefore concludes that fraud can be fought effectively within the current VAT system, provided efforts continue to strengthen administrative cooperation and make national control systems more effective. The early successes recorded by some Member States bear this out.

2. BACKGROUND

The Commission is required to draw up regular reports on the working of administrative cooperation in the field of VAT.

Three reports were submitted under Article 14 of the previous administrative cooperation regulation, Regulation (EEC) No 218/92.⁵ The first report dealt with the VAT Information Exchange System (VIES).⁶ The second⁷ examined the exchange of information under the Regulation. The third report covered both administrative cooperation and controls; it was submitted under both Article 14 of Regulation (EEC) No 218/92⁸ and Article 12(3) of Regulation (EC) No 1553/89.⁹

The recommendations in the third report provided a basis for discussions in the Council working group on tax fraud. On the basis of the working group's discussions, the Council, on 5 June 2000, adopted a series of recommendations to the Commission and the Member States (see Annex 1). The Standing Committee on Administrative Cooperation (SCAC) was instructed to follow up the recommendations concerning VAT.

This report summarises the action taken in follow-up to the Council's recommendations and seeks to examine whether this action was sufficient to cope with the challenge of VAT fraud. It also examines what additional action should be taken in the future.

This report is part of the work programme announced by the Commission in its recent communication on VAT strategy.¹⁰

3. THE CHALLENGE OF FRAUD IN THE PRESENT SYSTEM OF VAT

3.1. The present system of VAT and its control implications

In order to achieve the removal of border controls for tax purposes inside the Community from 1.1.1993, the Council decided in 1991 to establish the transitional VAT arrangements.¹¹ These arrangements provide that intra-Community operations between taxable persons continue to be taxed at the rate and conditions of the Member State of destination. An exemption for supplies of goods destined for another Member State was introduced to replace the exemption for exports and the taxable event of "importation" was replaced by "acquisition" in the Member State of arrival of the goods. The yearly value of those goods circulating within the Community without VAT is now more than 1 500 billions of euros (which represents 150 to 200 billions of euros of VAT receipts).

⁵ OJ L 24, 01.02.1992, p. 1.

⁶ COM(94) 262 final of 23.06.1994.

⁷ COM(96) 681 final of 8.1.1997.

⁸ OJ L 24, 01.02.1992, p. 1.

⁹ OJ L 155, 7.6.1989, p.9.

¹⁰ COM(2003) 614 final of 20.10.2003.

¹¹ Council Directive 91/680/EEC supplementing the common system of value added tax and amending Directive 77/388/EEC with a view to the abolition of fiscal frontiers (OJ L 376, 31. 12. 1991, p. 1).

Abolishing border controls resulted in the control of taxation of intra-Community trade being integrated into domestic VAT control, which required cooperation between Member States on a new scale. In particular, Member States needed information from other Member States in order to be able to control the tax since they were no longer able to obtain information about the flow of goods into their territory by the use of traditional customs controls at their frontiers.

This information, which form an input into Member States' methodology to control VAT on intra-Community transactions, is provided by the VIES which is a common computer network giving detailed control information about all exempt intra-community transactions.

In addition to the changes introduced by the transitional VAT arrangements described above, special arrangements in respect of the taxation of new means of transport, distance sales and sales to non-taxable legal entities were introduced. The purpose of these special schemes was to maintain the Member States' tax revenue by taxing at destination specific supplies of goods other than supplies between taxable persons. These special schemes, which are not dealt with by the VIES, also need special control. Generally speaking, to ensure correct taxation, it is necessary for there also to be a flow of information between Member States in respect of transactions under these schemes.

Special arrangements also exist in relation to certain intra-community services, particularly those services covered by Article 9(2)(e) of the 6th VAT Directive,¹² which are taxed at destination and subject to a "reverse charge" mechanism.¹³ Again, in order to make absolutely sure that the correct amount of tax is declared by the client in the country of destination, it is necessary for there to be a flow of information between Member States. However, the VIES data only relate to intra-Community supplies of goods, and therefore do not cover these supplies of services.

3.2. The fraud situation

3.2.1. VAT fraud has become a real worry in many Member States

Against this background, it has become clear to the Commission and to Member States that administrative cooperation as well as national control systems were still not fully adapted to this new situation created in 1993.

Though the detection rate of fraud is uncertain and the exact amount of money involved difficult to quantify, the amounts are undoubtedly considerable. Some Member States have estimated such losses as up to 10 % of net VAT receipts. VAT fraud has therefore become a real worry in many Member States. In addition to the loss of national revenue, this fraud jeopardises legitimate trade in certain economic sectors and distorts competition to the benefit of dishonest traders.

3.2.2. "Missing trader fraud" is a particular threat to the VAT system

One fraud pattern which seems to have grown over the past few years and which now represents a major concern for Member States is missing trader fraud in intra-community

¹² OJ L 145, 13.6.1977, p. 1. Directive as last amended by Directive 2003/92/EC (OJ L 260, 11.10.2003, p. 8).

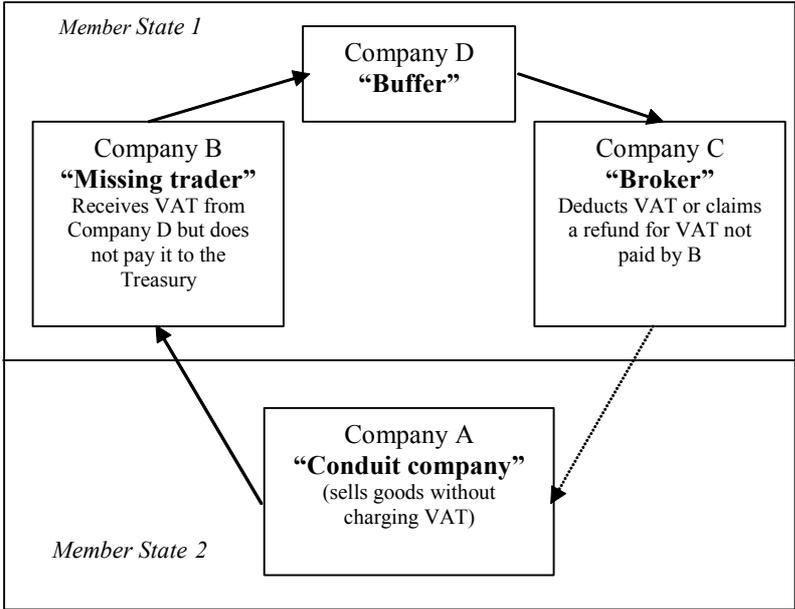
¹³ This means that the service is invoiced without VAT and that the tax is declared by the client, in a similar way to intra-community supplies and acquisitions of goods.

trade (the so-called “carousel fraud”). This fraud pattern might very well take advantage of the forthcoming enlargement to spread to the new Member States.

It works as follows. A so-called “conduit company” (A), makes an exempt intra-community supply of goods to a “missing trader” (B) in another Member State. This company (B) acquires goods without paying VAT and subsequently makes a domestic supply to a third company (C), called the “broker”. The “missing trader” collects VAT on its sales to the “broker”, but does not pay the VAT to the Treasury and disappears. The “broker” (C) claims a refund of the VAT on its purchases from B. Consequently, the financial loss to the Treasury equals the VAT paid by C to B. Subsequently, Company C may declare an exempt intra-community supply to Company (A) and, in its turn, (A) may make an exempt intra-community supply to (B) and the fraud pattern resumes, thus explaining the term “Carousel fraud”.

In order to distort VAT investigations, the goods will often be supplied from (B) to (C) via intermediary companies, called “buffers”. It may happen that the buffer is unaware of the fraud but in most cases he is conscious that he is involved in an irregular type of transaction (because of the unusual nature of the commercial transaction).

In practice, these kinds of fraud are constructed in a complex manner involving transactions between several Member States and several companies in each Member State. The underlying mechanism of missing trader fraud in intra-community trade can however be illustrated as follows:



4. COMMUNITY INITIATIVES TO TACKLE THE PROBLEM OF VAT FRAUD

The fraud situation was already described as particularly worrying by the Commission in January 2000 in its third “article 14” report and by the Council in June 2000.

The necessity to take certain urgent actions at Community level to tackle this fraud situation was stressed both in this Commission report and in the Council’s recommendations of June 2000. Most of these recommendations have led to concrete actions.

4.1. A new legal framework on administrative cooperation

In June 2001, the Commission made a proposal¹⁴ for a new regulation to strengthen cooperation between Member State tax authorities to combat VAT fraud. The Council adopted this proposal on 8 October 2003, and a new Regulation (No 1798/2003) on administrative cooperation in the field of VAT entered into force on 1 January 2004.

This Regulation sets up a single legal framework merging the legal apparatus of Regulation (EEC) No 218/92 and the provisions of Directive 77/799/EEC¹⁵ on VAT. This regulation has considerably improved the legal framework for administrative cooperation and is therefore to be considered as a major tool in the fight against VAT fraud.

4.1.1. More efficient rules

The new Regulation lays down clear and binding rules which will facilitate information exchanges. For example, clear and binding rules exist now on how a request for information shall be made, on how and when a reply shall be provided as well as on how to handle information exchanges with third countries.

It also lays down new rules enabling Member States to go further than a mere information exchange. For example, it is now possible for a tax administration to ask another tax administration to notify on its behalf a decision to one of its taxable persons established on the territory of this other Member State. It is also possible to make a specific request for an audit or even to ask for the possibility to send one its tax auditors to the other Member State in order to participate to an audit.

Those new tools will be very useful in situations where a taxable person is not established within the territory of the country and does not have any tax representative in this country or in situations where a company has all its accounting documents in another country than its own.

The possibility to ask for a specific administrative enquiry is also a very useful tool in tackling “Carousel fraud”. It will enable Member States to request other Member States to check the authenticity of a taxable person (address, activity, assets, identity of directors...) or to collect more evidence concerning suspected irregular transactions.

4.1.2. More direct contacts

The new Regulation also provides for direct contacts between tax inspectors of different Member States rather than always having to pass via Central Liaison Offices (CLOs). This will make cooperation faster and more effective. The Commission believes that direct communication between inspection staff or fraud units is the most effective way to speed up the exchange of information.

CLOs will still have the responsibility for managing administrative cooperation. However, all tax administrations may now also designate other liaison departments and competent officials who can directly exchange information. These may be regional services or specialised operational services (such as anti-fraud units) or individual tax inspectors participating in multilateral controls.

¹⁴ COM(2001) 294 final of 18.6.2001.

¹⁵ OJ L 336, 27.12.1977, p. 15.

It should be noted that direct exchanges have already been successfully operating in a limited framework, notably between local offices in border areas under bilateral arrangements.

All Member States can now make full use of the possibilities offered by the new regulation in this field, in order to facilitate direct exchanges of information between local offices as well as between national anti-fraud offices for whom rapid access to information coming from other Member States is a precondition to effectively combating intra-community fraud.

4.1.3. More information exchanges

Information exchange between Member States has been until now insufficient since outside the framework of VIES, there was little other spontaneous or automatic exchange of information. The main reason for this was the absence of any decision-making process at Community level to agree on such data exchanges. Agreements had therefore to be done on a bilateral basis. This was however not very effective and it was burdensome for tax administrations to manage different agreements, each one having its own rules.

The only exception was the multilateral agreement on new means of transport, which was signed on 27 November 2002 by 14 Member States. The agreement was negotiated in the framework of the SCAC but outside the formal comitology procedure.

The new regulation therefore aims at intensifying the spontaneous exchange of information between administrations in order to combat fraud more effectively. The new provisions provide for an obligation for Member States to exchange information in all cases where this could help other Member States in detecting and combating VAT fraud. The precise categories of information and the way in which the exchange will be handled by each Member State will soon be decided in an implementing regulation.

One major area of such information exchanges will be in respect of missing trader fraud, where the new regulation makes it compulsory to exchange certain information. This will help identify missing trader fraud and prevent registration of companies which are likely to engage in such fraudulent activities.

4.2. Fiscalis 2003-2007 programme

While the new regulation on administrative cooperation was a prerequisite in order to improve Member States' cooperation in the fight against VAT fraud, it was also necessary to accompany this legislative initiative by concrete measures enhancing cooperation between tax administrations and officials.

The Fiscalis 2003-2007 programme was therefore adopted by the Council and the European Parliament in order to enhance the day-to-day cooperation between officials. This programme provides funding for the organisation of seminars for tax officials, exchanges and study visits to other participating countries,¹⁶ multilateral controls¹⁷ as well as project groups where officials of different countries can work together in specific areas. This programme is also providing funding for the information technology systems in the area of taxation (mainly the VIES).

¹⁶ Participating countries are Member States, Acceding Countries and Candidate Countries.

¹⁷ A multilateral control is a simultaneous control, by two or more Member States, of the tax situation of one or more taxable persons who are of common or complementary interest.

The Fiscalis programme, which is a continuation of a previous programme but with a strong focus on the preparation for the enlargement, has a budget of 44 millions of euros over five years (subject to additional funding in the context of enlargement). One of its major objectives is to make it possible for the Acceding Countries to adopt as soon as possible the same level of cooperation and to reach the same level of control efficiency as the current Member States.

In order to meet this challenge, the Commission has already organised or planned under the Fiscalis 2003-2007 programme a number of specific actions for these countries. Several intensive training seminars have been organised for them in areas such as risk analysis, computer auditing and Carousel fraud.

4.3. A future Community initiative: VIES II

Other initiatives will be taken in the medium term to improve Member States cooperation in the fight against VAT fraud. In particular, the Commission is currently considering a revision of the VIES and its possible extension to services, which should help Member States to reinforce their controls.

When VIES was set up in 1993, it was built to last four years, the time the transitional VAT arrangements were initially expected to last. However, it has now been running for much longer. Though the system has been successful in providing control information on the bulk of intra-community trade, its shortcomings are more and more apparent.

Since 1993 Member States' use of the VIES has increased significantly. For example, Member States now make around 15 million requests per year for specific information over the VIES and the validation of VAT identification numbers over the internet is currently running at more than 3 million validations each month including VIES on the Web.

However few major improvements of a technical or functional nature have been put in place since 1992. The exceptions are the introduction of an electronic exchange of forms between CLOs and the exchange of information concerning electronically supplied services by taxable persons not established in the Community. Some efforts have also been made in order to improve the direct access of Member States to each others databases, as well as to anticipate the transmission of data. The technology, which was cutting edge in 1992 has therefore now become outdated.

In addition, the VIES has proved itself to be an inadequate tool in the fight against carousel fraud, not because of the slowness of the system itself, but because of the length of time that elapses before information on intra-Community acquisitions becomes available to Member States. There is normally at least three months between the date of the transaction and the date of such data transmission, which is often more than what is needed for a "missing trader" to disappear.

Another problem highlighted by Member States since 1993 is the incompleteness of the VIES data. The quality of the data sent over the VIES is dependent on the completeness and correctness of declarations submitted by taxable persons and the effectiveness of the system of sanctions for non-compliance with this obligation has often been inadequate. Given that taxable persons now have the right to submit recapitulative statements electronically,¹⁸ it is

¹⁸ See Article 22(6)(b) of the Sixth VAT Directive.

expected that more traders will opt for electronic submission of these statements, thereby increasing the quality of the data exchanged. Nevertheless, more could be done to automate the sending of data from taxable persons' records which would have the dual effect of reducing the burden of obligations on the taxable person and at the same time increasing the quality of the data.

For all of these reasons, the Commission has decided that the time has come to take a fresh look at the VIES: how the data is captured, made available and used. Rather than simply extending it to cover services, as suggested by the Council ad hoc working party on tax fraud, the Commission believes it would be better to replace the existing VIES with a more modern, higher-powered and flexible system, able to produce quicker and more precise data.

The Commission will therefore carry out this year a feasibility study with the intention of creating a new VIES within the lifetime of the Fiscalis programme 2003-2007. This new system should enable the exchange of information on intra-community trade to be carried out more rapidly and effectively and at less cost to taxable persons.

4.4. A future Commission initiative on mutual assistance in combating fraud

Coordinated mutual administrative assistance and the exchange of information (including between Member States and the Commission) are important elements in the fight against fraud. The Commission is therefore presently preparing a proposal for a Regulation on mutual administrative assistance for the protection of the Community's financial interests against fraud and other illegal activities. This initiative is intended to cover the fields of VAT fraud, laundering of the proceeds from EC fraud, structural funds fraud and other areas of fraud that are not yet covered by secondary EC legislation.

In the field of financial crime, the initiative aims at using the information obtained on the basis of the anti-money laundering tools in first and third pillar legal instruments for the purpose of the protection of the Community's financial interests. This means, in particular, tracing EC fraud through information on suspicious financial transactions.

This new initiative is complementary to existing legislation, in particular Regulation (EC) No 515/97¹⁹ providing for mutual assistance in respect of customs and agricultural matters, and also Regulation 1798/2003 on administrative cooperation in the field of value added tax.

5. CHANGES AT NATIONAL LEVEL IN RESPONSE TO THE COUNCIL'S RECOMMENDATIONS

Besides the many Community initiatives, the Member States have themselves made appreciable progress in the matter of VAT control, following up many of the recommendations made by the Council in June 2000. Most of these national measures have been coordinated at Community level in the SCAC framework.

Some reforms or advances nevertheless remain necessary for optimal cooperation between the Member States in their joint effort to counter fraud.

¹⁹ OJ L 82, 22.3.1997, p.1.

5.1. Major progress has been made

5.1.1. Greater use of the administrative cooperation machinery

The Member States are making ever greater use of the administrative cooperation machinery. Statistics kept by SCAC on recourse to the mutual assistance arrangements (see chart in Annex 2) show an appreciable increase in exchanges on request, be it under Article 2 of Directive 77/799/EEC or Article 5 of Regulation (EEC) No 218/92. The year-on-year increase in the total number of requests was 18% in 2000 and 29% in 2001. These figures stabilised in 2002.

The growth is attributable to growing awareness among the Member States of the importance of mutual assistance in VAT control and to the growing need for mutual assistance to counter fraud with a European dimension.

These efforts must be continued to make mutual assistance a routine instrument of tax control. This calls for a Community culture to be inculcated at every level of the tax administrations. Substantial efforts must therefore be made to bring home to auditors the importance of mutual assistance in VAT control. Considerable efforts are also needed to train auditors in Community tax law and other Member States' rules and practices. Ideally, auditors should have a good knowledge of at least one other Community language, which entails both a change in recruitment practices and increased training. Take-up of the support available under the new Fiscalis 2003-2007 programme must therefore be maximised.

5.1.2. More effective, more modern control

The Member States have embarked on a major modernisation of their control methods.

Two areas have received special attention: the setting-up of national risk-analysis systems and the development of computerised auditing.

5.1.2.1. Risk analysis

Risk analysis is an approach aimed at selecting businesses and sectors for control on the basis of the potential "risk" they represent. Scarce resources make such a system crucial to more efficient control. For instance, this system enables judicious use to be made of the voluminous data received from VIES.

All Member States have built a risk-analysis system into the organisation of their VAT control. Some have also developed dedicated VAT registration or refund systems. These systems serve to reduce to a minimum the time it takes most taxable persons to obtain a VAT identification number or refund. They also enable control to be focused on high-risk operators or sectors.

The Commission has consistently supported these developments, organising a number of seminars and financing many exchanges of officials via the Fiscalis programme. It has also worked with the Member States to identify good practice and developed a common methodology for identifying risk factors in order to help Member States construct their own systems. It will continue to support these efforts via a new risk-management project group.

5.1.2.2. Computerised auditing

Computerised auditing is a necessary response to the increasing use by businesses of electronic media for transmitting and storing accounting data (orders, delivery notes, invoices, accounts, etc.).

This modernisation of control methods entails both changes to the law to permit computer files to be used for control purposes (in those Member States where this is not yet the case) and efforts to acquire the requisite hardware and software and to train staff in the new methods.

In partnership with the Member States the Commission has drawn up recommendations aimed at modernising control methods in this way. Recent work in the SCAC has thus been aimed at helping the Member States move in this direction by providing them with guidelines.

These efforts seem to be bearing fruit in so far as most Member States are now making a particular effort to develop their computerised auditing capacities. Some Member States are also developing particularly innovative dedicated search engines for auditing e-commerce.

However, some Member States and a good many acceding countries still have no computerised auditing capacity. Community efforts in this area will therefore continue under the Fiscalis 2003-2007 programme, especially since the growth in e-commerce is bound to bring a commensurate increase in the use of computers for VAT invoicing and accounting. The adoption, on 20 December 2001, of Directive 2001/115/EC²⁰ to permit harmonised cross-border electronic invoicing has made this even more urgent.

5.2. The need for further progress

5.2.1. *Still inadequate coordination of national control plans*

Though the Member States are apparently starting to make routine use of mutual assistance for control purposes, there is still no real coordination of their control policies.

One of the key instruments of such coordination is the organisation of multilateral controls, i.e. coordinated controls of the tax situation of one or more taxable persons of common interest.

The Commission cannot but be alarmed at the fall in the number of such controls, which was already low, despite their being financed by the budget of the Fiscalis programme. Only three controls were organised in the whole European Union in 2003, four in 2002 and eight in 2001 (compared with 15 in 2000, a figure which was already low when set against the 1 500 000 businesses engaged in intra-Community transactions).

The clear downward trend is particularly worrying. It is no doubt connected with the practical difficulties of organising such controls. The adoption of the new Fiscalis 2003-2007 programme and the new Regulation on administrative cooperation in the field of VAT has, however, reduced these difficulties by speeding up financing and making the organisational rules more flexible, so permitting more frequent use of such controls, for instance to counter carousel fraud.

²⁰ OJ L 15, 17.1.2002, p.1.

This low level of activity must also be due to the low priority given by tax administrations to such controls, which mobilise considerable resources and demand multilingual staff.

It is also the result of the failure to take these multilateral controls into account when designing national control plans.

5.2.2. Remaining legal barriers to efficient administrative cooperation

Efficient use of mutual assistance in combating fraud also presupposes that this assistance is not hampered by national legislation that slows, blocks or complicates the exchange of information. This is why the Council identified certain specific obstacles and called for them to be removed.

Many of these obstacles have now been removed by the adoption of the new Regulation on administrative cooperation in the VAT field. This Regulation no longer requires the taxable person to be notified before any exchange of information, a procedure felt to be particularly unhelpful in fraud cases.

There remain, however, a number of obstacles, especially in the area of legislation on secrecy. Some Member States are denied access to certain information on legal grounds. They are therefore unable to transmit such information to any other tax administrations that might need it. This remains a major obstacle to effective administrative cooperation against fraud, and one that the Member States concerned must remove. A further obstacle is the fact that in most cases, a given Member State cannot take legal action against a debtor whose fraudulent activities only affect the tax receipts of another Member State. This is particularly deleterious in the effort to combat carousel fraud. For this reason and to remedy the existing problem, the Commission is planning by early 2005 to propose a Framework Decision in the third pillar context for subsequent transposition into national law.

5.2.3. An increasingly worrying lack of resources to meet new challenges

Lastly, making mutual assistance a routine instrument of tax control calls for sufficient resources to be allocated for handling the increasing number of requests for assistance.

Though some Member States have striven to give CLOs more resources, SCAC's statistics on exchanges of information (see table in Annex 3) suggest that more needs to be done. The number of late responses is still too high and is rising all the time. The year-on-year increase in the number of late responses was 27% in 2000, 24% in 2001 and 17% in 2002. If these figures are compared with the number of assistance requests each year, it emerges that more than half of responses are late.

So, the appreciable increase in recent years in the number of mutual assistance requests is threatening to overload the system either at the level of the departments responsible for assistance (in particular the CLOs) or at that of the control departments working under them. The next few years are, moreover, likely to see even faster growth owing to the entry into force of the new administrative cooperation Regulation and the EU's enlargement to 25 Member States in 2004.

There is therefore an urgent need for all Member States to address this trend by increasing staffing for mutual assistance (in CLOs and the new decentralised mutual assistance departments and in the control departments working under them).

6. ADDITIONAL INITIATIVES TO BE TAKEN TO MEET THE SPECIFIC CHALLENGE OF “MISSING TRADER” FRAUD

6.1. Adapting the control system to “missing trader” fraud

In addition to what has already been achieved at Community and national level as a response to the Council’s recommendations, additional initiatives have been taken in order to find appropriate solutions to the specific problem of “missing trader” fraud.

The Commission has, together with the Member States, carried out an in-depth examination of VAT fraud in intra-community trade and has identified the various measures that have been taken at national level and which have given the best results in the fight against “missing trader fraud”. These “best practices” are based on an enhanced and quicker use of mutual assistance and on an adaptation of national control systems in order to disrupt “missing trader fraud”. While the first aspect has already been addressed with both in the Council recommendations and in the new regulation on administrative cooperation, the second aspect requires additional efforts from individual Member States. Examples of the types of “best practices” which have been identified are set out below.

6.1.1. Measures to prevent “missing traders” from entering into the VAT system

It is in the first instance important to do everything possible to prevent missing traders from entering into the VAT system. In order to do so, tax administrations should identify bogus companies that are applying for VAT registration with the sole objective of carrying out fraudulent operations. To achieve this requires enhanced control at the time of registration of potentially suspect traders. This is normally accompanied by a combination of measures allowing the tax administration to impose financial guarantees, monthly VAT returns or special visiting programmes on suspect new traders.

6.1.2. Control techniques to detect “missing traders”

Despite these preventive measures, suspect traders may still slip through control at registration. It is therefore also necessary to set up specific intelligence and risk assessment systems in order to achieve an early detection of potential missing traders. Central risk assessment, such as analysis of VAT returns and VIES mismatches, should be complemented by operational intelligence, providing ‘real-time’ information derived for example from administrative cooperation.

6.1.3. Measures to stop detected “missing trader” fraud

Successful strategies to tackle “missing trader” fraud demand that early detection is combined with withholding of VAT refunds to the purchaser, awaiting the outcome of further investigation. Therefore, some Member States have adapted their legislation and administrative procedures relating to VAT refunds.

In addition, VAT numbers of missing traders simulating economic activities should be cancelled immediately in order to withdraw the possibility to continue acquiring goods without VAT payment and thereby stopping the fraud mechanism.

6.1.4. Recovery of VAT in cases of detected “missing trader” fraud

Once the fraud mechanism has been stopped, efforts have to be made to recover the unpaid VAT. Since there is no real possibility to recover the VAT from the missing trader, an

effective approach is to refuse the deduction or exemption of VAT to the other parties involved in the fraud.

In order to ease the burden of proof in complex fraud mechanisms, some Member States have recently enhanced their anti-fraud legislation by introducing a fiscal “joint or several liability”. Introducing such a liability implies that if a taxable person knew or should have known of the fraudulent activities of his co-contractor, he will be accountable for the payment of the VAT due by his co-contractor. In some Member States the introduction of joint and several liability has had a clear deterrent effect and seems to be effective. This measure finds its legal base in Article 21 of Directive 77/388/CEE, on condition that the principle of proportionality is respected.

6.1.5. Setting-up anti-fraud units

In addition to these measures, it is also necessary to adapt the organisation of the tax administration itself, in order for it to be able to detect and combat quickly and efficiently these types of international fraud. The specific and complex nature of “missing trader” fraud requires the existence of specialised anti-fraud and intelligence units with sufficient responsibility to ensure fast and effective action at all levels. These units should be given the necessary authority to exchange information quickly with their counterparts in other Member States.

6.2. Or adapting the VAT system itself

6.2.1. The different suggestions

National authorities, industry representatives and academics in several Member States have studied the possibilities of a substantial change in the way the VAT regime operates in order to tackle the problem of carousel fraud. Several of the suggestions concentrate on eliminating the combination of transactions on which VAT is paid and those on which it is not, and aim to ensure that transactions inside a Member State and intra-community transactions are accorded equal treatment throughout the EU. This can be obtained either by imposing actual payment of VAT on intra-community business-to-business (B2B) transactions or by suspending the payment of VAT on domestic B2B transactions.

Other solutions focus on the fact that Carousel fraud is only possible because taxable persons are allowed to recover VAT with no condition tied to the remittance of the tax to the Treasury by the missing trader.

6.2.1.1. Suspension of payment of VAT on all domestic B2B transactions

The financial losses caused by carousel fraud are due to non-payment by a missing trader of VAT that has been fully deducted by or reimbursed to another trader. Consequently suspension of payment of VAT on all B2B transactions offers certain advantages when it comes to combating carousel fraud, since there will be no deduction or reimbursement of VAT anymore.

Suspension of VAT payment can be achieved either by exemption of B2B transactions, or by a reverse charge mechanism whereby the client accounts for and deducts simultaneously the tax on his inputs with offsetting of input tax. However all these suggestions have considerable drawbacks.

Firstly, the effectiveness of such measure within the anti-fraud context can be questioned. Suspension systems undermine one of the basic principles of VAT, namely the fractionated payment mechanism designed to ensure that the tax system is self-policing and clearly shares out responsibilities between the buyer and the seller. In a suspension system the entire burden of tax collection falls on the retailer. Consequently this generates new opportunities for fraud and non-payment risks. Traders can go missing following B2C transactions in the same way as following B2B transactions, supplies to final consumers can be fraudulently declared as B2B transactions and the overall possibility to buy at net prices could spread further the underground economy (where sales are simply suppressed).

Secondly, it would demand from tax administrations substantial additional resources for personnel and technology. All B2B transactions would have to be reported and cross-checked. In addition, control of B2C transactions would have to be reinforced because the entire burden of tax collection would fall on the retailer.

Thirdly, it would entail a considerable extra administrative burden for traders. As under the current system for intra-community transactions, all domestic transactions would have to be declared to the authorities and traders would have to check their customer's VAT status.

6.2.1.2. Suspension of payment of VAT on certain domestic B2B transactions

Theoretically, the suspension system could be limited to certain categories of traders or supplies. Some tax administrations have suggested applying the reverse charge mechanism to certain sectors or suggested an optional suspension system. However, in addition to the above-mentioned drawbacks, this would lead to the coexistence of domestic B2B trade with and without payment of VAT. Consequently, it could create the potential for purely domestic Carousel fraud constructions by combining normal domestic transactions on which suppliers charge VAT to their customers and domestic transactions which are under the suspension system.

6.2.1.3. Actual payment of VAT on all intra-community transactions

Another possibility would be to charge VAT on all intra-community transactions within the EU. This would reinstall the mechanism of fractionated payments, which ensures that the tax system is to some extent self-policing. If VAT were paid on all incoming and outgoing transactions, only the difference between input VAT and output VAT could be at stake and the financial risks of missing trader fraud would become much less. Consequently, this would eliminate the loopholes in the current system that cause missing trader frauds. It is exactly this type of system which the Commission has always envisaged as the ideal definitive system of VAT within the Internal Market (the so-called "origin system").

Imposing actual payment of VAT on all B2B intra-community transactions would ideally be at the rate applying in the Member State of origin.

There would however have to be a system of reallocation of revenue from the country of origin to the country of destination. Such a regime would also demand a far greater degree of harmonisation than currently exists. There would for example have to be a much greater degree of approximation of rates. In the short run, this degree of harmonisation cannot be achieved because of differing domestic arrangements in the Member States and because of the importance which most, if not all Member States, attach to their fiscal sovereignty in respect of fixing the level of their tax rates.

Such a system could also operate by applying the rate of the Member State of destination but this would be burdensome for traders as the current exemption system would be replaced by the application of VAT at a rate which would differ for each purchaser. All intra-community traders would therefore need to know the rate applicable for their products or services in all Member States.

6.2.1.4. Actual payment of VAT on certain intra-community transactions

Most cases of carousel fraud involve high value goods which are easy to transport such as computer components and mobile phones.²¹ Theoretically, actual payment of VAT on intra-community transactions could be restricted to those economic sectors. Charging VAT on the intra-community transactions would of course eliminate missing trader frauds using high risk goods. However, the same revenue allocation and tax harmonisation issues would arise as in a full origin system. Moreover, other kinds of goods could be used such as cars, textiles, telephone cards, food, soft drinks, metal products, alcohol, petrol, etc. Consequently although it would tackle the fraud in the most vulnerable sectors, the fraud could, at least partly, be moved to other sectors.

6.2.1.5. Tying VAT deduction to the payment of the tax or its remittance to the Treasury by the supplier

Missing trader fraud is only possible since taxable persons are allowed to deduct VAT independently of the supplier's remittance of the tax to the Treasury. Therefore certain national authorities are studying the possibilities to amend the rules on deduction of VAT by linking them to some extent to the supplier's remittance of the tax. It goes without saying that the right to deduct is a basic principle of VAT and all measures restricting this right should be strictly in line with the principle of proportionality.

Another suggestion envisages making use of the option provided by Article 10.2 third paragraph of the Sixth VAT Directive to enhance the rules on deduction of VAT. Member States may for certain transactions or certain categories of traders provide that the VAT becomes due (and therefore deductible) only at the moment of the payment of the price. In order to be really efficient, such a system would be accompanied by a cross-checking system.

Such a system would however place additional burdensome obligations on traders.

6.3. The Commission's view

The Commission welcomes the fact that Member States are reflecting on introducing certain legislative measures (e.g. the reinforcement of the rules on VAT deduction) in order to protect the VAT system against serious abuses such as missing trader fraud. The Commission will, in close cooperation with the Member States continue to pool best practice in this field and in the light of the experience gained consider whether there is a need to modify Community legislation.

The idea of going further and changing the VAT system itself to tackle VAT fraud may look attractive at first sight. However care must be taken not to create any new opportunity which may turn out to be as serious as, or even worse than, the existing fraud. This would particularly apply if exemptions were generalised. Furthermore any proposed change needs to be examined carefully from the perspective of the potential administrative burdens they might

²¹ However, around 40 different sectors have been identified so far.

create for honest traders. Similarly, the demands on tax administrations in terms of additional resources for personnel and technology required to establish and maintain databanks, process data and perform the necessary controls need to be assessed.

It should also be stressed that solutions exist to tackle this fraud within the existing system of VAT. The Commission indeed notes that those Member States (notably the Netherlands and the United Kingdom) which have already implemented the specific detection and control measures referred to under paragraph 6.1 to tackle “carousel fraud” have been successful.

All these measures, together with the other initiatives recently taken by Member States in the area of control plus the legislative initiatives recently taken at Community level (the new regulation on administrative cooperation, Fiscalis 2003-2007 programme and VIES II), should represent appropriate and sufficient measures to meet the specific challenge of missing trader fraud.

In addition to what has recently been initiated in this field, there is also a need to explore the establishment of a common and comprehensive EC concept of fiscal fraud and the harmonisation of penal sanctions.

Consequently before any radical change is made to the VAT system, the Commission considers that further efforts should be made to tackle fraud under the current system by continuing to work for the improvement of administrative cooperation and VAT control systems in the Member States.

7. CONCLUSIONS AND RECOMMENDATIONS

7.1. Conclusions

The Commission followed up the Council’s recommendations by proposing a stronger legal framework for administrative cooperation. This led to the adoption, on 7 October 2003, of a new Regulation on administrative cooperation in the VAT field and, on 3 December 2002, of the Decision on the Fiscalis 2003-2007 programme. In the medium term the Commission is also planning to propose the modernisation of the VIES system.

The Member States have also made significant progress towards complying with the Council’s recommendations.

They have been making much greater use of mutual assistance. The rising trend in the number of mutual assistance requests is set to continue, and even accelerate, owing to the enlargement of the EU and the adoption of the new Regulation on administrative cooperation in the VAT field.

The Member States have made headway in rendering their control procedures more efficient and modern, notably by adopting risk-analysis systems and investing in computerised auditing.

In addition to the body of measures taken to follow up the Council’s recommendations, there has recently been much discussion aimed at finding solutions to the specific problem of intra-Community fraud (and in particular carousel schemes).

One solution is to adapt control to these new fraud mechanisms. A list of good practices has therefore been identified at Community level in cooperation with the Member States. The Member States which have gone down this road are already recording considerable successes.

Some national authorities, professionals and academics have proposed another solution, namely to reform the working of the VAT system itself. Various options exist, but all have disadvantages which far outweigh the potential benefits.

It is therefore preferable to continue efforts to strengthen administrative cooperation and make national control systems more effective, in order to reap the benefits of recent national and Community reforms, rather than embarking on the hazardous path of reforming the VAT system itself, an approach that involves more risks and uncertainties than it offers solutions.

Finally, the ten new Member States must adopt the same standards on control systems and mutual assistance at the earliest possible date.

7.2. Recommendations

- The Member States must continue to make intensive use of the administrative cooperation machinery. They must make the best possible use of the facilities offered by the new Regulation (notification, request for an administrative inquiry and presence of officials on the territory of another Member State).
- They must allocate the human resources needed for carrying out more numerous multilateral controls and build such controls into their national control plans.
- They must remove the remaining legal barriers identified by the Council so that VAT controls are equally effective throughout the territory of the EU.
- They must adopt as quickly as possible a national plan to reduce the average response time to mutual assistance requests.
- To do this they must rapidly allocate additional resources for mutual assistance either to CLOs or to services on the ground, and they must use to the full the decentralisation possibilities afforded by the new Regulation to ensure that increasing use of mutual assistance does not overload the system.
- They must continue their efforts to make tax control more efficient and modern. Those Member States which have yet to adopt computerised auditing must do so as soon as possible.
- They must implement as quickly as possible the good practices identified in the matter of carousel fraud (see point 6.1), and in particular set up national fraud departments empowered to exchange information with the other Member States.

Annex 1

Recommendations made by the Council in June 2000

1- Recommendations which fell within the Commission's competence

- (1) Eliminate all existing legislative obstacles at Community level so as to allow swift and effective administrative cooperation among the various Member States in cases of tax fraud or in the event of clear signs of fraudulent practice.

In particular, it would be necessary to:

- consider introducing exceptions to the various secrecy provisions hampering or delaying the exchange of information;
 - examine the possibility of setting shorter time-limits for the exchange of information on the most serious cases of fraud;
 - dispense with prior notification of the information exchange to the taxpayer;
 - clarify the ambiguities in Directive 77/799/EEC and examine the limitations on the use of information;
- (2) Amend Community legislation with a view to providing more direct contact between the control authorities of the various Member States. This objective may, for example, be achieved with the presence of officials taking part in control activities in other Member States, which may lead to increased effectiveness in combating fraud. These joint control operations would in every case be the subject of bilateral or multilateral agreements and under the direction, control and responsibility of an official of the Member State in which the inspection is carried out.
 - (3) Study the possibility of amending the VIES system in order to consider including supplies of services, particularly those under Article 9(2)(e) of the 6th VAT Directive;
 - (4) Amend Regulation (EEC) No 218/92 and Directive 77/799/EEC leading preferably to the establishment of an appropriate single legal framework to enable cooperation in the fight against fraud to be reinforced, thus removing the obstacles identified above.
 - (5) Examine the rules laid down in the Sixth VAT Directive with the aim of simplifying them and submitting a relevant proposal for a Directive as soon as possible.

2- Recommendations which fell within the competence of Member States

- (1) Eliminate all existing legislative obstacles at national level so as to allow swift and effective administrative cooperation among the various Member States in cases of tax fraud or in the event of clear signs of fraudulent practice.

In particular, it would be necessary to:

- consider introducing exceptions to the various secrecy provisions hampering or delaying the exchange of information;

- examine the possibility of setting shorter time-limits for the exchange of information on the most serious cases of fraud;
 - dispense with prior notification of the information exchange to the taxpayer;
- (2) Amend national legislation with a view to providing more direct contact between the control authorities of the various Member States. This objective may, for example, be achieved with the presence of officials taking part in control activities in other Member States, which may lead to increased effectiveness in combating fraud. These joint control operations would in every case be the subject of bilateral or multilateral agreements and under the direction, control and responsibility of an official of the Member State in which the inspection is carried out;
 - (3) Study the possibility of amending the VIES system in order to speed up access to information made available under the VIES system, bearing in mind that the time factor plays a major role in fraud mechanisms, so that administrative cooperation will need to be made simpler and speedier through this system, as through others;
 - (4) Provide Central Liaison Offices (CLOs) with appropriate human and material resources, organising their proper liaison with control departments and, in particular, with anti-fraud squads, so as to ensure that scheduled reply times are met and that quality information is exchanged;
 - (5) Develop efforts to ensure that local or regional control departments, depending on each Member State's own organisation, have the necessary human resources to enable them to reply promptly to information requests from the other Member States and follow them up in the appropriate manner;
 - (6) Consider the relevance of direct contacts, with a prior mandate from the competent authority, regarding specific cases or types of case: multilateral control measures and the direct transmission of data in cases of fraud or in the event of clear signs of fraudulent practice, in cross-border areas and joint investigations;
 - (7) Organise mechanisms providing for administrative sanctions in the case of late submission of such statements; organising the timely handling of such statements and promoting the speedy rectification of errors found in them, so that data are forwarded within the stipulated period and are as complete as possible. The implementation of measures in this area would speed up the flow of more reliable information and therefore enable it to be used for risk-analysis purposes and for better orchestrated control operations;
 - (8) Step up, by means of agreements, the spontaneous and automatic exchange of information, particularly in specific cases or operations which generally entail a higher risk of fraud or tax evasion, such as distance selling and sales of new means of transport for private individuals.
 - (9) Optimise selection methods on the basis of "risk analysis". These methods, without prejudice to subsidiarity and in so far as is possible, should be based on principles common to the various Member States, which remain to be defined.
 - (10) Endeavour to take account in their national inspection plans of certain guidelines based on common denominators of tax evasion and fraud, preferably and where

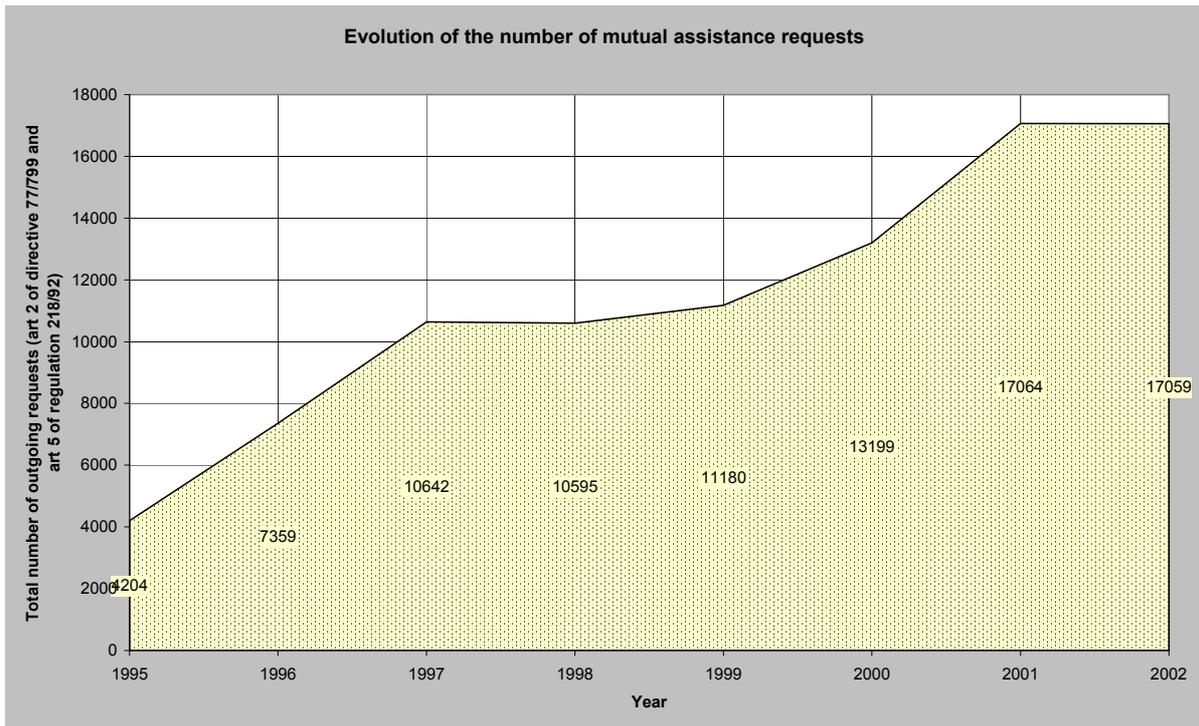
possible defined in accordance with the methods referred to in the preceding recommendation, specifically with the aim of combating fraud in a concerted manner and not on a case-by-case basis and reaching conclusions on the frequency of certain types of fraud within the Community.

- (11) Define a strategy for monitoring registration procedures, taking into account alarm signals pointing to the incidence of possible fiscal fraud. If it is established through checking that the activity is not being carried out or that the conditions for its performance do not exist, the Member States should consider precautionary measures;
- (12) Adapt control systems to the realities of electronic commerce and introduce widespread use of computerised procedures in auditing;

3- Recommendations which required Community action (other than legislative)

- (1) Study the possibility of amending the VAT Information Exchange System (VIES) in order to allow each Member State direct access to the VIES database of the other Member States, subject to safeguards to be determined subsequently, in order to prevent violation of commercial secrets, etc., thereby making it possible for it to identify those of its taxable nationals who are the recipients of intra-Community transfers from a given operator registered in another Member State.
- (2) Optimise selection methods on the basis of “risk analysis”. These methods, without prejudice to subsidiarity and in so far as is possible, should be based on principles common to the various Member States, which remain to be defined.
- (3) The taking into account in Member States’ national inspection plans of certain guidelines based on common denominators of tax evasion and fraud, preferably and where possible defined in accordance with the methods referred to in the preceding recommendation, specifically with the aim of combating fraud in a concerted manner and not on a case-by-case basis and reaching conclusions on the frequency of certain types of fraud within the Community.
- (4) Adaptation of Member States’ control systems to the realities of electronic commerce and introduce widespread use of computerised procedures in auditing;
- (5) Request the Multidisciplinary Group on Organised Crime actively to pursue its efforts to ensure that certain types of VAT fraud are combated more effectively.

ANNEX 2



ANNEX 3

